

For Distribution

Remarks of
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Federal Energy Regulatory Commission

"Competition and Electricity Networks, Here and Abroad"

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Ladies and Gentlemen,
Madames and Messieurs --

I.

Thank you for this opportunity to help elucidate the forces that are changing the uses of the transmission system in the U.S. and, in particular, the challenges that the industry and its regulators must face as competing views of the emerging power market are sorted out. I think that this distinguished panel will find in what I have to say some echoes of what they themselves are experiencing. In most advanced, electrically developed countries, the process of

reducing regulation by positioning generators to compete over the wires for larger, even trans-national markets is a common theme. We are no different.

The biggest thing we are doing at the Federal Energy Regulatory Commission to usher in the new millennium is to articulate and then make real a vision of the electricity industry that entails fundamentally new assumptions, structures, and businesses. Today, American policymakers and students of the industry are engaged in a wide-ranging discussion of customer choice, new reliability rules, green power, new pricing paradigms, and so forth. Electric restructuring has yet to catch the popular imagination, however.

At the wholesale or "bulk power" level, where FERC regulates, the current debate is relatively narrow. We are focused on price volatility, the long-term effects of mergers and so forth. But the crux of the debate

starts and ends with the future of the transmission system. Our objectives at the Commission are simple: encourage management of grid operations and the pricing of transmission services on a broad, regional basis, ensure non-discriminatory transmission access, and deregulate the sale of power wherever competition permits. Open access to essential transmission facilities was the initial concept, but regional transmission organizations, or RTOs, is the only structural remedy that will make open access a reality. RTOs will transform the balkanized and often inefficient bulk power market of today into the transparent and competitive environment we see in the future. The Commission is therefore strongly urging the U.S. utility industry to fall in behind that vision, under a voluntary program set forth in Order No. 2000.

Let me acknowledge that there is a growing trend toward competition in the West generally. The E.U.

countries and the U.S. have taken different paths with respect to regulating electric service. We started by "unbundling" transmission services and requiring open access to transmission service before the states began tackling retail issues. Conversely, European power market "liberalization" started in the retail sector and is now focusing on trans-national grid management issues. However, in many ways our experiences are similar. We both favor competitive supply policies. We both have what I would call "federalism" issues; in the U.S., individual states can either frustrate or advance competitive policies adopted at the national level, first because retail distribution markets are so highly integrated with the operations of the bulk power system and, also, because there are jurisdictional distinctions in our laws that are remnants of a less diverse and dynamic energy economy and an era when wholesale transactions were less important. Similarly, certain member countries of the E.U. are also in a position to delay or retard

benefits of a more fluid European cross-border electricity trade. Equally important, there remain substantial differences about the role of competition, law and regulation and about the merits of vertical integration of utility functions, which looks peculiar from our perspective.

While the E.U. is ahead of schedule in liberalizing retail markets, effective retail customer choice must necessarily await open access to transmission throughout the E.U. and the supply options that will then be available.

II.

Electric markets in the U.S. and Europe are fragmented for the same reasons. Past technology meant that economies of scale required central station power plants and that transmission over long distances was not possible. Technology constraints also meant that utility monopolies were the most efficient way to

supply electricity. In both cases, smaller political divisions (i.e., states and municipalities) were adequate to oversee franchise monopoly utilities, which served largely within their borders. Although "privatization" is a word seldom heard in our policy debates, we too have state-owned utilities (i.e., TVA and the federal power marketing administrations) and they have posed a rather unique obstacle to open wholesale markets.

Now, American and European markets are changing, and again for the same reasons. New developments in generation and transmission mean that small power plants are highly efficient and that transmission over long distances is possible. These technological changes mean that it is possible for competitive markets in electricity to extend over much larger regions.

In the U.S., competition came to wholesale markets in 1978, when Congress encouraged non-utility generation under PURPA. During the Eighties more than half of the generation that came on line in the U.S. came from non-utility generators in an increasingly competitive market. In the early Nineties, the Congress realized that competition in wholesale markets was both possible and practical, and in the Energy Policy Act of 1992, allowed greater dependence on non-utility generation. It gave FERC limited authority to require wheeling over the grid, including across the systems of non-jurisdictional entities. Today, despite this precedent, there are nevertheless many skeptics in our Congress who are unsure that the Commission should be able to go further, even though it cannot effectively promote universal open access, much less efficient markets, under the limitations of current law. For example, over the one-third of the transmission system lies beyond our existing jurisdiction. Nor do we have sufficient authority to

advance regional market development through RTOs, except on a case by case basis. But that's another story.

In any event, electric loads are coming to depend more heavily on large regional markets for supply, instead of on local suppliers of electricity. The wholesale market is making itself more important. Since 1996, wholesale transactions in the U.S. have increased 400 percent. We have therefore allowed trading patterns to develop and have encouraged market institutions that mirror the realities of this market. There are new problems arising from the new uses of the transmission system, most notably congestion.

One coincidental but important aspect of the emergence of markets is the question of whether regulatory institutions will be capable of ensuring that the transition to a competitive market takes place timely, without undue economic dislocations and the

ability of monopoly incumbents to exploit market dominance, and consistent with the public interest. I confess to you all that our success in these regards is only partial at best.

When we tried to bring competition and open access to the transmission system one transaction at a time (in our Order No. 888), we had only a partial solution to undue discrimination, market power, and a lack of transparency. It required all transmission owners to post a tariff stating rates, terms and conditions for competitors' use of transmission that were comparable to the rates, terms, and conditions under which the utility used its own system. But, some essential ingredients were missing.

We lacked jurisdiction over much of the grid. Non-jurisdictional entities owned fully one-third of the transmission network. We knew that, of course. But we also, perhaps naively, concluded that open access and

comparability would come to the remainder, even though the rates and terms of service for interstate transmission dedicated to retail "native load" ("bundled retail transmission"), were historically regulated by the several states. In truth, open access has not been the rule in that part of the grid either.

Notwithstanding these flaws in our plans, open access proved popular in principle. Four years into that effort, however, the Commission concluded that the only way to ensure that competitive wholesale electricity markets could develop was to establish a new institutional foundation. Transmission systems had to be operated independent of any vested interest in the competitive generation market. Those markets also had to be large enough to allow power suppliers to compete over long distances. We developed the RTO concept to overcome the barriers to competition, discrimination against certain uses of the grid, and fragmented control of the system.

The Commission's interest in RTOs coincided with numerous other developments that threatened competition and reliable service. In the past few years, generation resources were being acquired over increasingly large regional areas; interregional transfers of electricity were increasing; open access transmission, competition and a booming economy led to the divestiture of a large share of generating assets; merger activity increased; new industry participants, including independent and affiliated power marketers emerged; the volume of trade in industry increased; states began to introduce retail competition; and new physical stresses on the transmission grid appeared.

The fear grew that demands on the transmission system might exceed the ability of system operators to respond. For the first time, the FERC was called on by industry to help ensure reliability through mechanisms like transmission line loading relief. Debates intensified about whether the planning and construction

of transmission could keep pace with increased system requirements and unprecedented high spot market prices.

The exercise of market power, the lack of new transmission capacity, the diversity of market participants, and even regulatory restrictions conspired to cause problems that now demand both market and public policy solutions. We must decide how to promote more efficient management of congestion on transmission facilities, how to ensure accurate determinations of available transmission capacity (ATC), how to deal with parallel path flow issues, how to address the prevailing uncertainty associated with transmission planning and expansion, how to eliminate pancaked transmission rates, and how to thwart the temptation of transmission providers to unduly discriminate in favor of affiliated power market participants.

In Order No. 2000, the Commission proposed RTOs as a way to both separate generation and transmission interests structurally and to achieve all these goals on a regional basis. Eventually, we want all transmission owning entities in the Nation, including non-public entities, to place their transmission facilities under the control of appropriate regional transmission institutions. This approach replaces the historical approach of having multiple operators over a regional grid which is clearly an inefficient arrangement.

It may sound bold but Order No. 2000 is remarkably unprescriptive. RTOs may be for-profit or non-profit. They can be an Independent System Operator (ISO), a transco, or a hybrid structure. RTOs can own transmission facilities, lease them, or operate facilities owned by others. In any event, each RTO must satisfy four cornerstone characteristics, at a minimum. It must be independent of market

participants, big enough and so configured as to reflect market realities, actually have operational control of the regional grid, and it must be responsible for short term reliability. In addition, each RTO must perform eight functions, including:

- . tariff administration and design
- . congestion management
- . parallel path flow
- . ancillary services
- . OASIS, TTC, and ATC
- . market monitoring
- . transmission system planning and expansion, and
- . interregional coordination

RTOs are not an end in themselves, of course. Because bigger markets work better, RTOs are the platform for pricing innovation, better price signals, and inducements to good grid operation. We expect market mechanisms to manage congestion. With the advent of RTOs, pancaking of access charges will be

eliminated, but we expect that a stand-alone business that thrives on increasing throughput and serving customers will emerge.

In Order No. 2000, the Commission also decided to focus on the need for investment as well, partly because the transmission system, while a relatively small part of any retail rate, is critical to markets. If we have an approved RTO, it would be eligible to seek a rate moratorium (based on existing rates that are state controlled); a formulary rate of return or other innovative approach to setting its equity returns; risk premiums; or non-traditional depreciation rates for new investment; levelized recovery of capital costs; or performance-based rates.

III.

The prognosis is still unclear. RTOs will undoubtedly form voluntarily in some regions; they may languish elsewhere. We will begin to know this fall.

Meanwhile, the U.S. Congress is embroiled in debate about the extent of state jurisdiction over the interstate trade in electricity and the new mechanisms for ensuring reliability. The E.U., which is exercising central authority over member states in opening markets, may see success more quickly than the U.S., which (despite a strong tradition of central oversight of interstate commerce) has no national plan to get to competitive markets, other than Order Nos. 888 and 2000. Planning, operation, and pricing must be performed across much larger regions and the ability of one governing body like an RTO to set and enforce uniform rules of the road is vitally important.

Existing divisions of responsibility between federal and state regulators have served us well historically. Like so many things, they may make less sense in an era when competitive markets and non-discriminatory transmission access are more important

than traditional cost-of-service regulation. Yet, some shifts in regulatory responsibility between state and federal entities may accompany the arrival of competitive markets.

The modern role of the transmission network is to support competitive generation markets and reliability. In our view, its independence and its disinterest in who wins and loses that competition is key. Trust in the fairness of transmission services will be the coin of the realm. That is why the evident choice of Germany, France and Japan to retain vertical integrated utilities appears so strange to me. Transmission users will be required (to paraphrase President Reagan) to "trust but verify."

Electric reliability, transparent markets, and new investment in transmission and generation are too critical to the public interest for the law and the future to be unclear. A slow transition to competition

creates uncertainty and indecision and lessens the incentive to build new facilities. A market as dynamic and diverse as this one necessitates some measure of government direction and oversight. I can only hope that the Congress can help us find just the right answers. In my opinion, those answers promote markets without "re-regulating" an industry that seems to be seeking ways to shed its monopoly characteristics.

IV.

We are making solid strides toward a regionalized approach to electric transmission in the U.S. The solutions we are finding can be employed wherever such a network industry is in the midst of transition but our answers may not always be serviceable across the Atlantic, where utility and regulatory philosophies may differ from ours. In an era of global competition, it will be interesting to see which models attract the greatest investor confidence.

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Thank you.